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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 699

J. W. NEFF AND ELIZABETH A. NEFF, PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The first opinion of the Court of Claims (Pet. 1a–11a) is reported at 301 F. 2d 330. The second opinion (Pet. 21a–32a), rendered on respondent's motion for reconsideration, is reported at 305 F. 2d 455.

JURISDICTION

The judgment of the Court of Claims was entered on July 18, 1962. A timely motion for reconsideration or rehearing was denied on October 3, 1962. The petition for a writ of certiorari was filed on December 28, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Petitioner, J. W. Neff owned 98 of the 100 shares of outstanding stock of J. W. Neff Laboratories, Inc. The corporation distributed $19,035 to Mr. Neff in redemption of 47 shares of its stock. The question presented is whether the Court of Claims erred in holding that, on the facts of this case, the distribution was "essentially equivalent to a dividend" and therefore taxable as ordinary income rather than capital gain under Section 302 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock.*

(A) *In general.*—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

* * * * *

(C) *Definitions.*—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

* * * * *

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. * * *

* * * * * *

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.302–2 *Redemptions not taxable as dividends.*

* * * * *

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. * * *

* * * * *

STATEMENT

J. W. Neff Laboratories, Inc., originally a consulting engineering firm, was incorporated on May 24, 1938, with an authorized capital of 500 shares of $10 par value common stock (Pet. 13a). At the time of the transaction involved here, the company's outstanding stock was owned as follows (Pet. 14a):

	Number of shares
J. W. Neff (President)	98
Elizabeth A. Neff (his wife)	1
C. Oakley McFadden	1
Total	100

On September 30, 1954, Mr. Neff transferred 47 of his 98 shares to the company for $19,035 (Pet. 14a).

During the prior years 1944 through 1954, the only dividend the company had paid was in 1949 (Pet. 15a). For the period 1950 to 1954, inclusive, this was due at first to a desire on the part of management to retain earnings in the business and later because the company had losses and management believed it could not afford to pay cash dividends (Pet. 20a). The company had never paid stock dividends or split its stock (Pet. 20a).

According to Mr. Neff, the redemption resulted from his reluctant agreement to provide stock so that the company would have shares available to sell to raise needed additional capital (Pet. 16a–18a). However, at the time of the redemption the corporation had no commitment to sell the redeemed shares (Pet. 27a). The company was authorized to issue 500 shares, and could have satisfied its need for capital by the sale of authorized but unissued shares (Pet. 18a). The evidence is that no consideration was given to the authorized but unissued stock by either the company's lawyer, who had incorporated the company and acted as its counsel for the entire period between its organization and the date of the redemption, or by Mr. Neff, who was one of the incorporators of the company and had been its dominant officer and stockholder throughout its history (Pet. 17a–18a).

In the period between five and fifteen months after the redemption, the company sold 38 of the 47 shares of stock it acquired from Mr. Neff. As a result of these sales, Mr. Neff's proportionate interest in the company was materially changed (Pet. 19a).

The Court of Claims held (Pet. 11a–29a) that the $19,035 received by Mr. Neff on the redemption of 47 shares of his stock was a distribution essentially equivalent to a dividend and therefore taxable as ordinary income, rather than as capital gain, under Section 302 of the Internal Revenue Code of 1954. Judge Laramore dissented (Pet. 29a–32a).

ARGUMENT

The court correctly applied the law to the particular facts of this case. There is no conflict of decisions and no cause for review.

The taxpayer, essentially the sole owner of a corporation (Pet. 27a), received a distribution of $19,035 in redemption of approximately one-half his share holdings. The redemption left his ownership interest virtually unchanged. The sole question presented is whether the distribution was essentially equivalent to a dividend and therefore taxable as ordinary income under Section 302(b)(1) of the Internal Revenue Code of 1954. The answer turns upon the facts and circumstances of the case (see Treasury Regulations on Income Tax (1954 Code), Section 1.302–2(b), *supra*, p. 4; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 233 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4870, quoted in the petition at page 8), and these were properly assessed by the court below.

The taxpayers complain that the corporation had a valid business purpose for redeeming the stock and for that reason the distribution should have been treated as a sale rather than a dividend. They refer to the corporation's need to raise additional capital

and the plan to sell the shares obtained from the taxpayer. The court, although acknowledging the existence of the need, properly held that it did not convert this distribution from a dividend to a sale. See *Holsey* v. *Commissioner*, 258 F. 2d 865, 869 (C.A. 3); *Northup* v. *United States*, 240 F. 2d 304, 307 (C.A. 2). In any event, the court found that the redemption "was devoid of any * * * real relationship" to the corporate need for additional capital. Its finding is amply supported by facts. Thus, even assuming a desire not to increase the number of outstanding shares of stock, the same corporate purpose could have been achieved without any payment to the taxpayer—Mr. Neff could have turned in one-half of his shares for subsequent sale by the corporation.

There is no merit to taxpayers' argument that the Court of Claims improperly looked to the taxpayer's interest in the corporation immediately before and immediately after the distribution (Pet. 6–7). These facts may be pertinent to a determination whether a distribution is a substantially disproportionate redemption entitled to capital gains treatment under Section 302(b)(2). There is, however, no bar to considering the same facts when determining whether a distribution was essentially equivalent to a dividend under Section 302(b)(1).[1] Neither *United States* v. *Carey*, 289 F. 2d 531, 535 (C.A. 8) nor *Radnitz* v. *United States*, 187 F. Supp. 952, 956 (S.D. N.Y), is

[1] The short answer to taxpayers' contention that the court should have recognized the corporation's subsequent sale of the shares some five to fifteen months after their redemption to be part of the original transaction, is that the court's holding to the contrary is amply supported by the facts.

to the contrary (Pet. 6–7). These cases do not hold that the court, in determining whether a distribution is essentially equivalent to a dividend under Section 302(b)(1), must disregard the taxpayers' ownership interest immediately before and after the redemption. Rather, they merely restate Section 302(b)(5) which provides that the fact that a redemption fails to qualify under the specific exceptions in Subsections (2), (3) and (4) shall not preclude a finding that the redemption is entitled to capital gains treatment under Subsection (1). Neither *Carey* nor *Radnitz* holds that the court must blind itself to all the facts that would be pertinent under those subsections when proceeding under Section 302(b)(1).

There is no merit to the taxpayers' other contentions. Other decisions cited by taxpayers, *Commissioner* v. *Snite,* 177 F. 2d 819 (C.A. 7); *Decker* v. *Commissioner,* 32 T.C. 326, affirmed on the Tax Court's findings and opinion, 286 F. 2d 427 (C.A. 6); and *Smith* v. *United States,* 130 F. Supp. 586 (C. Cl.), are distinguishable on their facts.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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